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Fix Corruption First To Improve Philippine Security

**Noah Christian Cloud**

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## **Abstract**

The Government of the Philippines has been plagued by corruption for many years and each administration since WWII has committed to fighting it, but has had little success. The impact of this extensive corruption is exacting negative consequences on the economic prosperity and security of the Philippines. From an economic perspective, the Philippines is having a tough time attracting foreign direct investment to support critical growth requirements and billions are being lost from corruption in the administration of customs duties. Furthermore, these losses are partially responsible for sustaining a large underground economy that is also used by criminals and terrorists to conduct illicit transactions. Moreover, criminals and terrorists act with impunity due to large levels of corruption in law enforcement, the military, and in the judiciary, which is negatively impacting the security environment. Furthermore, the recent increased aggression from China towards the Philippines is further degrading the security environment. Although recent GDP growth rates in the Philippines are high, there is more potential for increased and sustained growth with less corruption. The U.S., utilizing all elements of national power, should first focus its efforts on helping the GOP fix public corruption. In doing so, the Philippines will increase its self-sufficiency as it realizes the additional resources from reduced corruption. Increased resources with a better overall investment environment will encourage meaningful and sustainable positive change in the Philippines.

## **INTRODUCTION**

The Philippines has been dealing with high levels of pervasive corruption within its government for some time. Despite many attempts by multiple regimes to address corruption, the Government of the Philippines (GOP) has had limited success. To achieve meaningful progress toward lasting security, fixing corruption should be a priority. Similarly, before Washington invests in strengthening theater security ties with Manila, it should focus on reducing corruption in the Philippines first, leveraging all instruments of national power.

The U.S. should focus on fixing corruption within the GOP for several important reasons. First, corruption is a problem that has existed within the GOP for a long time and it has infiltrated nearly all GOP institutions. Second, the GOP has proven incapable of overcoming corruption on its own and needs the assistance of the U.S. Third, corruption is negatively impacting both economic prosperity and security within the Philippines. Improvements in these areas will improve self-sufficiency and increase the amount of resources necessary to make significant and sustained progress within the Philippines. Also, decreasing corruption should provide an environment more conducive for increased levels of investment which fosters lasting prosperity.

### **History of Corruption in the GOP**

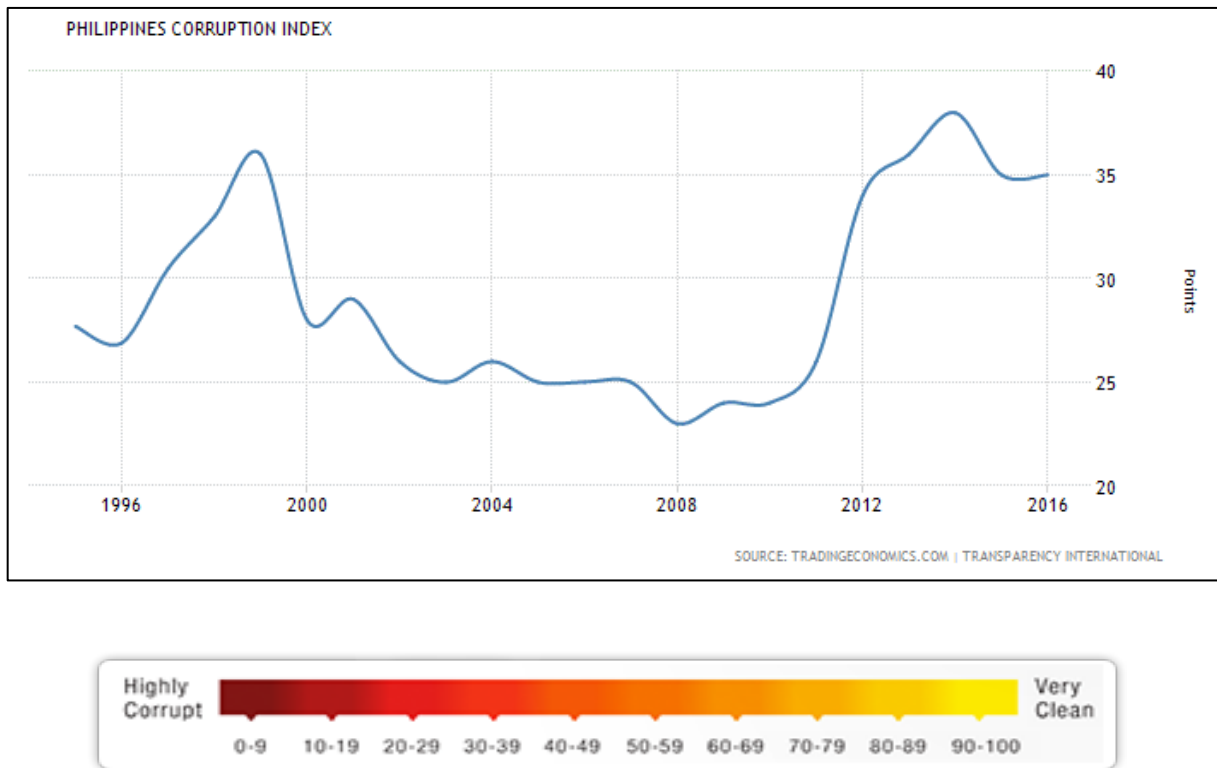
A historical review is a useful way to gain both context and appreciation for where the corruption came from, its evolution over time, and why it is still so extensive today. Jon Quah presents his historical perspective in the summary below:

The Spanish first introduced corruption into the Philippines as part of their colonization efforts in the 16<sup>th</sup> Century. Throughout their colonial period graft and corruption

became rampant as officials bought and sold positions of power as a matter of routine business..<sup>1</sup> This lasted until 1898 when the Americans replaced the Spanish and began working to clean up corruption by offering higher salaries and better working conditions for civil servants..<sup>2</sup> This era ended with World War II (WWII) which left the Philippine bureaucracy with few resources and low prestige, setting the conditions for renewed political corruption..<sup>3</sup> Since WWII, eleven different administrations have come to power and each has been plagued with different levels of controversy regarding corruption.

Although many Philippine Presidents since WWII have pledged to eradicate corruption or have devoted significant resources to do so, efforts have fallen short. To graphically highlight where the Philippines is currently perceived to be, in terms of corruption, graph 1 (below) presents a Corruption Perception Index (CPI) score from 1995 – 2016 from Transparency International (TI). The CPI measures the perception of corruption in the public sector as perceived by business people and country analysts. TI ranks the Philippines as the 101<sup>st</sup> worst country out of 176 countries in 2016 in terms of corruption..<sup>4</sup> Furthermore, the most recent corruption trend is negative, further degrading an already poor standing by placing the Philippine corruption score at 35 out of 100 (graph 1). Along with having a poor overall score in 2016, the Philippines is listed on TI's "too soon to tell" list due to "President Duterte's dramatic rise to power...[and] the impact of [his] death squads, attacks on media and violent intimidation to the detriment of democracy and democratic institutions yet to be seen in 2017.."..<sup>5</sup> The concern being that his actions may further degrade government institutions and lead to increases in the levels of corruption. Although it is too soon to tell what impact the Duterte administration will have on corruption, the history of

corruption coupled with the recent trend indicate corruption will likely be a significant problem in the future.



Graph 1. Philippine Corruption Perception Index..<sup>6</sup>

In addition to a long history of corruption at the highest levels of government, lower-level corruption across multiple institutions is also a serious problem in the Philippines. For instance, “the Hong Kong-based Political & Economic Risk Consultancy (PERC) group ranks the Philippines as having significant institutional corruption; PERC reports that the military is the most corrupt Filipino institution, followed by the tax and customs bureaus and the police.”<sup>7</sup> Similarly, the 2013 GAN Business Anti-Corruption Portal identifies corruption across all the public institutions within the Philippines. It reports that there is extensive corruption within the judicial system including the police and the public services; within land, tax, and customs administration; and in the public

procurement and natural resources.<sup>8</sup> It goes on to report that anti-corruption legislation is complicated and not enforced effectively. Additionally, basic civil laws including freedom of speech, freedom of expression, and freedom of the press are suppressed by the government. Complicated laws, poor law enforcement and government suppression of basic rights only work to exacerbate the issues surrounding pervasive corruption across most of the GOP.

Corruption in the GOP has significantly degraded nearly all government institutions as well. The laws, committees, agencies, and bureaucracies instituted to prevent or punish corruption in the Philippines has done little to overcome it.<sup>9</sup> Moreover, the CPI has moved up and down a little bit as administrations have changed power, however, the overall level of corruption has remained relatively high.<sup>10</sup> Based upon the lack of success in overcoming corruption in the last 70 years, it is doubtful that, without assistance from the United States or some other country or organization, the GOP will be able to make significant progress to end corruption on its own. Understanding the negative impacts of corruption help shape recommendations for how the U.S. can use the elements of national power to assist the GOP.

### **The Negative Impact of Corruption on Economic Prosperity**

Corruption negatively impacts economic prosperity within the Philippines. The most impactful losses are in terms of: Foreign Direct Investment (FDI), infrastructure investment, and internal tax receipts. One of the most important investment sources is FDI, but this is also the most deficient source of investment in the Philippines. Although the Philippine emerging economy is currently experiencing high growth rates of 6.5 to 7.5 percent, increasing levels of FDI are an important requirement for economic



growth.<sup>11</sup> The GOP actively pursues FDI internationally to spur economic growth, but it ranks the eighth worst out of 10 among the Association of Southeast Asian Nations (ASEAN) countries in terms of FDI received as a percentage of GDP. This low ranking is mostly due to limits on foreign ownership, corruption, poor infrastructure, and regulatory inconsistency.<sup>12</sup> The U.S. State Department's 2016 Investment Climate Statement on the Philippines cites additional reasons for limited FDI:

Inadequate public investment in infrastructure and lack of transparency hinder foreign investment. Philippine regulatory regimes remain ambiguous in many sectors of the economy, and corruption is a significant problem. A complex, sometimes corrupt, and slow judicial system is also a major disincentive to investment.<sup>13</sup>

To attract both FDI and internal investment requires an environment that fairly balances risk and reward for the investor, however, corruption is making investment too risky. Philippine Treasury Secretary Ramon Lopez recently cited increased infrastructure investment as a catalyst for moving the Philippines into the top three to five FDI countries within the region in the next five years.<sup>14</sup> Such a marked improvement in terms of FDI is ambitious, but it is worth noting that it is difficult to determine what is having a greater impact on FDI in the Philippines—is it poor infrastructure or corruption?<sup>15</sup> That being said, addressing infrastructure over corruption is likely to produce suboptimal FDI in the Philippines. Moreover, infrastructure investment programs in the Philippines are troubled by corruption.

President Duterte's "golden age of infrastructure" program is a recent and powerful example of government acknowledgement of corruption. According to an *Agency France-Presse* news article, President Duterte has put special emphasis on a \$170B infrastructure investment program, primarily financed by Japan and China, to

spur growth; however, “about 10 to 30 percent of an infrastructure’s project cost is typically lost to corruption, according to Vincent Lzatin, executive director of the Transparency and Accountability Network in Manila.”<sup>16</sup> The article goes on to say that for projects directly involving congressmen, the level of loss rises to 50 percent. As examples, the article highlights two high value projects of \$593M for rail expansion and \$300M for broadband expansion, both financed by China, that were cancelled due to corruption scandals. Perhaps China is willing to trade influence for resources, but as seen here, it is not without risk, especially concerning large scale infrastructure projects. If infrastructure investment is critical to attracting FDI for growth, then losing up to 50 percent to corruption significantly impacts growth opportunities. Although loss of FDI due to corruption contributes to slower economic growth, the greatest loss of resources occurs due to corruption within the Philippine customs bureau.

The financial losses for the GOP due to corruption within the import/export sector of the Philippine economy are dramatic. Global Financial Integrity’s (GFI) 2014 report on financial flows in the Philippines states that the greatest loss of revenue receipts for the Philippine government occurs due to mis-invoicing of trade through the customs bureau.<sup>17</sup> It goes on to cite that roughly 72% of illicit financial outflows and 96% of illicit financial inflows are attributable to trade miss-invoicing. Consequently, illicit flows drain money from the domestic economy in the form of tax and customs evasion. It reports that roughly 25% of the annual value of imported goods go unreported to the official customs system. Since 22% of total taxes come from international trade, this has a “severely damaging effect on government revenues.”<sup>18</sup> The report claims that from 1990 - 2011, the Philippine government lost \$23B in

customs revenue and that illicit financial flows have cost the Philippine government an average of \$1.46B in tax revenue annually since 2000. Furthermore, the \$3.85B in lost revenue in 2011 was more than twice the size of the fiscal deficit and 144 percent of the 2017 annual defense budget.<sup>19</sup> These losses are staggering in magnitude and as they represent losses in resources that could be applied to improving the Philippines economy or its security. The corrupt transactions associated with these financial losses occur in the underground economy.

The underground economy is sometimes referred to as a black market or a shadow economy and it is used for buying and selling goods and services 'off the books' or outside of official channels without having to pay taxes. It can be used to avoid paying taxes or to hide transactions from the government. The 2014 GFI report states that much of the lost revenue from corruption goes to finance an "underground economy" in the Philippines which, as of 2011, has grown to become 35 percent the size of 2011 GDP.<sup>20</sup> The order of magnitude of revenue lost due to corruption is staggering when compared to the 2017 annual budget of \$67.02B. Furthermore, government receipts and subsequent spending are a vital part of the growth engine for the Philippine economy in 2017.<sup>21</sup> The underground economy, although it likely provides some goods and services that are not criminal in nature, is costing the GOP billions in lost revenue that could otherwise be used towards economic growth and security. Although corruption is a big problem in the GOP and there has been little success in overcoming it, there are several examples of other countries within the region that have had success, such as South Korea.

Although different in many ways from the Philippines, South Korea serves as a model of precedence and success for overcoming corruption.<sup>22</sup> For example, South Korea successfully increased revenue by reducing customs' corruption. Dev Kar and Brian LeBlanc's research on illicit financial flow of funds compares South Korea to the Philippines in terms of trade mis-invoicing over time. It correlates illicit flows of funds to the World Bank's "Control of Corruption" Governance indicator. It concludes that improved governance, partially through the control of corruption in South Korea, has reduced the loss of revenue which has yielded opportunity and growth for South Korea, a result not seen in the Philippines.<sup>23</sup> Large losses of resources due to corruption is not new to the region but there are examples of other countries that have overcome these problems. This example offers an important precedence and provides a perspective that corruption can, in fact, be overcome and lead to positive economic outcomes, even within the Pacific region, one troubled by corruption.<sup>24</sup>

The sheer magnitude of the financial losses due to corruption and the inability of the GOP to overcome it is troubling. The GOP has the incentive and the means to reduce corruption but has not been able to do so. With the assistance of the U.S. to reduce corruption and address the economic impacts of corruption shown above, the GOP can harness the lost resources to gain increased self-sufficiency. Increased self-sufficiency may enable the GOP to better care for its own priorities and needs. Similarly, reducing corruption may help improve the environment for FDI, increased infrastructure investment and stem the size of the underground economy. There is precedence for success in targeting corruption to increase revenue; and with additional focus and

resources from the U.S., South Korea's success may possibly be replicated in the Philippines.

### **The Negative Impact of Corruption on Security**

Corruption in the Philippines is similarly exacting a heavy toll on security within the Philippines for several reasons. The large underground economy along with corruption in the judiciary, the police, and the military are severely degrading the security environment. Furthermore, President Duterte's efforts to increase the fight against crime employs the suspicious use of a "slush fund" while China's recent actions make the security environment even more complicated to address.<sup>25</sup> Understanding the underground economy's impact on the security environment is important in moving toward a recommendation for helping the GOP.

To address the impact of corruption on security in the Philippines, one important aspect addressed previously is the underground economy that enables, supports, and incentivizes both criminal and terrorist activity. In the Philippines, the magnitude of the flow of funds as a percentage of the total economy is of great concern. Research indicates that the larger the underground economy becomes, the higher the expected level of government corruption.<sup>26</sup> The converse is also true in the Philippines, the higher the level of government corruption, the higher the expected size of the underground economy.<sup>27</sup> These relationships are troubling because each aspect encourages the other, so both must be simultaneously addressed. Furthermore, while the underground economy enables many transactions that are not innately criminal, criminals take advantage of these markets to conduct their illicit transactions.

International Alert's 2014 policy brief on Mindanao, Philippines states:

These so-called “shadow economies” include the proliferation of illegal firearms, kidnapping for ransom, informal land markets, cross-border trade, informal credit provision and illegal drug markets...Shadow economies can be a source of conflict because they embody a significant amount of economic and political capital for local strongmen, armed insurgents and powerful clans... People choose to transact in the informal economy because formal markets are absent or poorly functioning.<sup>28</sup>

Although Mindanao is one of the more violent locations within the Philippines in terms of extreme crime and terrorism, it is important to understand the nature of the underground economy there.<sup>29</sup> It supplies a channel for transacting in both legitimate and illegitimate products and services, so it is a complex issue for the Philippine government. As stated, many aspects of this underground economy provide sorely needed services; however, other aspects provide an outlet for corrupt and illicit activities that negatively impact security. In addition to aiding in the creation of an illicit market place, corruption in the legal system and similarly enables crime and terrorism.

The security environment in the Philippines is very complex. The Philippines’ inefficient court system, lack of resources and qualified staff along with significant nepotism, favoritism, and impunity for the political and business elite add to the troubles of an underfunded system.<sup>30</sup> The problems in the judiciary are only expanded by having to wait an average of 15 years for a public corruption case to come to trial.<sup>31</sup> This weak system has created a belief that justice serves only those who can afford it.<sup>32</sup> In other words, if you have status or money you can manipulate the judicial system to escape consequences associated with criminal activity. Thus, the judiciary system has little deterrent effect on criminal activity as it renders wealthy criminals relatively safe

from prosecution. Law enforcement and the military have similar problems with corruption.

Law enforcement has little deterrent effect on crime due to poorly coordinated efforts among policing agencies, high levels of bribery, unreliable protection for businesses from extortion and crime, and police themselves are systematically involved in extortion and abuse of their office.<sup>33</sup> The Philippine government, especially President Duterte, is keenly aware of this predicament, as were his predecessors (see Table 1). In 2017, President Duterte renewed the government's focus on these problems by significantly increasing resources to suppress drugs and crime.<sup>34</sup> Of note is the increase in his "highly discretionary" intelligence and confidential funds that he holds under the Office of the President, which was increased by over 400 percent compared to 2016; there is concern that this \$50M fund is prone to abuse.<sup>35</sup> It is yet to be seen what impact this fund will have on crime and corruption, but these efforts are not new.

With respect to the Philippine military, one of its primary concerns is terrorist activity in the southern portion of the Philippines, primarily in Mindanao. These terrorist organizations have been linked to high-profile kidnappings and ransoms which raised millions of dollars to support their activities.<sup>36</sup> There have been multiple incidents of collusion reported among terrorist organizations, the Philippine Army, the Philippine police, the central government of the Philippines, down to local governments.<sup>37</sup> The collusion includes illegal firearms sales, illicit trade in drugs, and kidnappings for ransom.<sup>38</sup> Concerning these matters of collusion, unless serious action is taken to investigate and severely discipline those responsible, the environment may remain less secure.<sup>39</sup> This is yet another example of corruption within the government

yielding significant risk to the security environment and should be strongly considered by the U.S. Government when operating in a combined operation with the Philippine Army. The GOP's security concerns have recently become more difficult to address with the aggressive actions taken by China.

The Philippines, until 2011, focused their resources primarily on internal security issues; however, with its territorial disputes with China in the South China Sea, the Philippines decided to balance their resources against both internal and external threats.<sup>40</sup> With all the economic challenges facing the Philippines, having to divide attention and resources to support an external threat from China while continuing to fight internal threats is a problem. The expanding external security threat with existing levels of corruption internally, places the U.S. – Philippine security alliance at risk.

By working directly with the GOP to end corruption, the U.S. can help the GOP increase security to become more self-sufficient and make meaningful progress. First, reducing corruption in the police force, the military, and the judiciary reinforces the rule of law. This increases confidence in the GOP and reduces the number of criminals and terrorists. Also, by arresting, capturing and prosecuting criminals and terrorists, this should increase security and render the total problem of corruption more manageable. Second, resolving internal threats should make dealing with the external threat from China more tenable. Finally, less corruption will likely have a positive financial impact than can improve security. As the underground economy and criminal / terror networks are effectively managed, the more financial resources should become available to revitalize the armed forces to counter the threat from China and other internal threats. Better security and improved self-sufficiency should make the

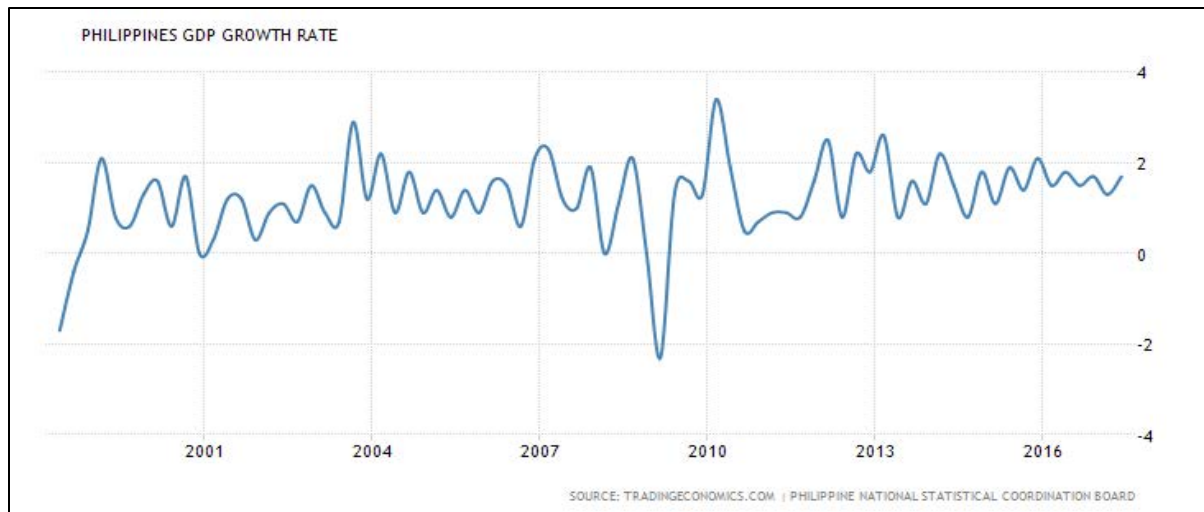


Philippines more attractive, increasing the levels of investment and capacity for even more success.

### **Philippine GDP Growth and Corruption**

Although corruption is having a negative impact on economic prosperity and security, the Philippine GDP is growing at a very promising rate. In fact, the Philippines is the 10<sup>th</sup> fastest growing economy in the world. In 2017, it grew between 6.5 and 7.5 percent.<sup>41</sup> Based on these statistics, one can argue that the Philippine economy is on the right track. The problem with this conclusion is that it discounts the actual impact of corruption. The right question to ask is whether or not the Philippines can do better with less corruption. Graph 2 indicates that the Philippines has had less volatile growth rates recently but that the overall average level of growth does not appear to be increasing over time. Would even more sustained levels of growth be possible with lower levels of corruption? It is difficult to predict the future with all the economic variables at play. Economies are multi-faceted and complex, so it is possible that an independent economic variable or a combination of variables are at play in the Philippines, causing current growth rates to exceed 6.5 percent—even with high levels of corruption. It could be possible that these higher growth rates anticipate a future reduction in corruption due to the recent changes within the Duterte administration.

Causation is very difficult to prove with all the variables that impact GDP growth rates. A comparison of graphs 1 and 2 indicate a correlation between corruption and economic growth (prosperity) in terms of volatility in growth rates, less so in terms of real growth. However, there are many variables at play in an in both corruption and economic growth so drawing any supportable conclusions is speculative at best.



Graph 2. Philippine GDP quarterly growth rate.<sup>42</sup>

### Conclusion

The totality of the evidence and analysis provided suggests that corruption is deeply rooted within the Philippine government. It is pervasive throughout all levels and institutions. The inability to successfully reduce corruption over time has led to significantly negative impacts on both economic prosperity and security in the Philippines. The GOP is incapable of reducing corruption on its own to deal with these impacts and needs assistance from the U.S. Government to do so. The U.S., as a treaty partner with the GOP, has a vested interest in creating a more stable and self-sufficient Philippines capable of providing for its own increased economic growth and enhanced security. Revenues created from reduced corruption can be used to revitalize the military and police forces along with added investment resources for new infrastructure needed to attract FDI. A Philippines with drastically reduced corruption should enjoy the same type of success experienced by South Korea, which dealt with similar corruption issues. In doing so, more internal and external investment can be utilized more effectively to provide for the people of the Philippines and counter

aggression from other nations, like China. Helping the GOP to reduce corruption first is a long-term endeavor that will require the full complement of the U.S. elements of national power and will likely face some setbacks along the way. Mr. Saddiq, the CEO of Afghanistan International Bank, would likely agree that corruption is indeed difficult to overcome but the cost of not doing so is far worse.

### **Recommendations**

Long term reduction of Philippine corruption will ultimately require all elements of national power: diplomatic, informational, military, and economic power (DIME). The U.S. has an opportunity to make difference by applying the following DIME approach:

1. Diplomatic: (This element is also needed to enhance all others)

*Influence the GOP to honor its 2003 commitment to the United Nations Convention Against Corruption (UNCAC).*<sup>43</sup> Utilize direct diplomacy and United Nations (UN) support to influence the GOP to: (1) enact whistleblower protection and Freedom of Information laws. (2) Strengthen /enforce witness protection programs. (3) Create an independent process for appointing anti-corruption agency heads. (4) Move the burden to pursue a complaint to the government rather than the citizen.

*Use diplomatic pressure directly and via the UN to highlight transparency with the GOP.* Continue to report the lack of transparency in the GOP and influence the enforcement of U.S. laws against doing business with corrupt governments. Ensure the GOP is aware of the U.S. Government interest in anti-corruption.

*Increase pay for rule of law advocates.* Utilize diplomatic efforts to encourage the GOP to pay a living wage to members of the judiciary, law enforcement, and the military

to reduce the need for individuals to participate in corrupt activities to meet basic needs.

*Re-focus U.S. Agency for International Development (USAID) on anti-corruption activities.* USAID should focus its efforts on ending corruption in the GOP first.

## 2. Information:

*Improve/increase information operations(IO) and public affairs within the GOP.*

(1) Assist the GOP in developing an anti-corruption campaign within the Philippines that incorporates U.S. assistance. (2) Assist the GOP in developing an information strategy to influence the elite class within the Philippines to work against corruption. (3) Drastically increase the Philippine media awareness of transparency within the GOP to expose corruption. Use all media channels to maximize the influence on the electorate within the Philippines.

## 3. Military:

*Improve/increase Philippine Armed Forces' professionalism.* (1) Increase the levels of morale and ethical training during combined training exercises in the Philippines. Additionally, send trainers into the Philippine military education system to help instruct Philippine cadre on how to teach moral and ethical behavior across their armed forces. (2) Station U.S. ethics trainers at key military training institutions within the Philippine armed forces education system. (3) Increase the number of Philippine officers sent to U.S. military institutions of higher learning such as war colleges, military academies and even basic military training and Non-Commissioned Officer Education System (NCOES) schools.

*Monitor and aid in disabling the underground economy.* Provide U.S. Government resources from across the government to train and advise the GOP on how to best counter illicit activities that fuel the underground economy.

4. Economic:

*Study and recommend a simpler, faster, and more transparent bureaucracy.* (1) Provide the GOP business process audit services to map business processes and associated controls that are currently in place with special emphasis on the import /export sector, the infrastructure sector and customs. (2) Follow the audit with an implementation strategy, milestones and monitoring services. (3) Partner with the GOP to audit the anti-corruption laws within the financial system and recommend improvements based upon international best practices and norms.

*Monitor and aid in disabling the underground economy.* Provide U.S. Government and academic expertise to analyze the Philippine economy to identify gaps in services that need to be filled within the economy to degrade illicit activity.

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